11 April 2019

How far will financial speculation go? After prices, pandemics - What next…?

For long, speculators were content to bet on changes in commodity prices or in bond value. Of recent, financial speculation has become interested in disasters. How?

We have recently drawn the attention of our readers to the growing importance given to private funding of development by promoting capital markets participation through the creation of 'green bonds' and infrastructure bonds in particular [read]. We saw then that the policy of promoting private funding of development supported by large international financial agencies (World Bank, IMF and regional development banks) threatens to undermine social and environmental development objectives, while weakening public financial organisations by making them bear most of the risk.

Photo Kenny Katombe. Reuters

A very similar phenomenon is occurring in the area of financing emergency aid in case of disasters.

Back in 2015, "Extreme Mortality Bonds" (or "Mortality Catastrophe Bonds") started to be discreetly sold to financial operators. These financial products serve to bet on the level of mortality resulting from disasters and they are designed to transfer part of the risks from insurers to capital markets as selling these bonds supplies insurers with capital, thus contributing to the resources available to them in case of disaster.

The mechanism is extremely simple. The financial operators buy bonds that yield interest while the reimbursement of the principal is scheduled to take place at the end of the contract. If the mortality resulting from the disaster covered by the bond exceeds a certain severity threshold, a share of the value of the bond, specified in the contract, can be used to cover expenses incurred by the emitting organisation (the insurer), thus diminishing by the same amount the capital reimbursed to the speculator at expiry of the contract. In case the trigger threshold has not been reached before the end of the contract, the speculators recover the full capital they have invested; otherwise they will only have gained the interests collected during the lifetime of the contract and the share of capital remaining at expiry [read]. This kind of system is widely used by insurance companies, but it is the first time, in our knowledge, that an official development assistance organisation uses it.

It is therefore this principle that was used by the World Bank in June 2017 at the time of the establishment of its "pandemic bonds". These bonds have been very popular with financial operators, particularly pension funds and CAT bonds investors. In case of the Ebola bonds, the trigger threshold - and therefore the point from which speculators would lose a share of their capital - was fixed at 250 cases *and* the disease outbreak involving simultaneously the Democratic Republic of Congo (RDC) and one of its neighbouring countries. The level of interest paid is high (between 6% and 11%), and the sale of these bonds allowed the World Bank to raise for its Pandemic Emergency Financing Facility (PEF) money immediately available to act in case of a disease outbreak (altogether more than $300 million). During the 2014/2015 Ebola outbreak, emergency activities on the ground had been delayed as the World Bank had been obliged to make an emergency appeal for funds with donors only once it had been aware of the crisis.

It is quite clear from this that the definition of the trigger threshold and the monitoring of the indicators that define it, are of utmost importance, as it is the crossing of the threshold that authorises the bond issuer (in our case the World Bank) to use a predefined share of the capital it holds to fund emergency activities. And it is quite easy to imagine the perverse effects the nature and level of the threshold could have on the behaviour of parties involved - countries, aid agencies, speculators, not forgetting those who have the responsibility to measure the indicators used to determine whether the threshold has been crossed or not - and the possible financial drifts that have already started to occur [read in French]. What follows in this article will give some idea of that…

One thing is clear, however, that is that in case of absence of disaster as characterised by the threshold defined in the contract, these bonds can constitute a source of considerable profit, given the high level of interest rate. The other advantage of these bonds for financial operators, is that they can use them to improve their image and communicate on their willingness - if not their eagerness - to mobilise funds to assist people who are victims of disasters.

In reality, according to Guillaume Lachenal's article in the French newspaper *Libération* [read in French], the outcome achieved after two years of operation of the "pandemic bonds" for Ebola shows that the main beneficiaries were private speculators. Out of $140 million spent by the World Bank, around $20 million went to funding the response to the on-going Ebola outbreak in DRC, while most of the rest of the expenditure - around $110 million - was siphoned by speculators through the interests paid to them! This makes these financial operators look more like vultures than like philanthropists!

The lion share of official development assistance funds therefore went to the world of finance! And this happened despite the fact that the on-going epidemic is the second most serious Ebola outbreak in History and has more than the 250 cases specified in the bonds contract (in fact, according to Lachenal, it has 1,100 cases and 700 casualties in Ituri and Kivu provinces of DRC). But, the trigger threshold stipulated in the contract has not been crossed, as it specified that the outbreak, in addition to presenting more than 250 cases, should *also* involve at least one of the neighbouring countries of DRC. But, so far, the epidemic has been confined to the RDC.

This is one of the perverse and horrible aspects of this story: for the World Bank to use part of the capital, *would it not be better to let the virus cross a border*?

In the meantime, if this does not occur, speculators will continue to be paid their interests and full amount of capital, even if the number of victims of the epidemic were to grow much more.

How long will it take before big aid agencies launch financial products on floods in Mozambique, Zimbabwe or elsewhere? On famines in Yemen or the Sahel? The imagination of finance has no limits when what is at stake is to intrude in all facets of the economy and of our live in order to make more profits!

To know more:

- Lachenal, G., Ebola : les marchés financiers jouent à gagnant-gagnant, Débats, Libération, 2019. (in French)
- Artemis, Pandemic cat bond remains at-risk as Ebola virus spread continues, Artemis, 2019.
- Lachenal, G., Tombola Ebola, Débats, Libération, 2018 (in French).
- Milhench, C. and A. Roche, World Bank launches 'pandemic bond' to tackle major outbreaks, Reuters, 2017.
- Ramakrishnan, S. et J. Wiltermuth, Extreme mortality bond testing investor view on pandemic risk, Reuters, 2014.
- Banque mondiale, Pandemic Emergency Financing Facility, website.

Earlier articles on hungerexplained.org related to the topic:

- Opinions : World Bank Financializing Development, 2019.
- Privatisation of development assistance: integrating further agriculture into the world market, 2018.